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STATE CORPORATION COMMISSION

October 18, 2019

Hon. Joel H. Peck, Clerk
State Corporation Commission
c/o Document Control Center
Tyler Building, First Floor
1300 East Main Street
Richmond, Virginia 23219

RE: *Application of Virginia Electric and Power Company, For the determination of the fair rate of return on common equity pursuant to § 56-585.1:1 C of the Code of Virginia,* Case No. PUR-2019-00050

Dear Mr. Peck:

Please file the enclosed original and fifteen (15) copies of the attached "Post-Hearing Brief of The Staff of The State Corporation Commission" with the other papers in this proceeding.

Thank you for your assistance in this regard.

Sincerely yours,

Andrea B. Macgill
Associate General Counsel

ABM:jpr

cc: Service List

COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

APPLICATION OF

VIRGINIA ELECTRIC AND POWER COMPANY CASE NO. PUR-2019-00050

For the determination of the fair rate of return on common equity pursuant to § 56-585.1:1 C of the Code of Virginia

POST-HEARING BRIEF OF THE STAFF OF THE STATE CORPORATION COMMISSION

I. PROCEDURAL HISTORY

On March 29, 2019, Virginia Electric and Power Company d/b/a Dominion Energy Virginia ("Dominion" or "Company") filed with the State Corporation Commission ("Commission") an application ("Application") for the determination of the fair rate of return on common equity ("ROE") to be applied to its rate adjustment clauses pursuant to § 56-585.1:1 of the Code of Virginia ("Code") and to measure earnings in the first triennial review proceeding in 2021 under Code § 56-585.1:1 A. Enacted in 2015, Code § 56-585.1:1 requires that:

> Commencing in 2017 and concluding in 2019, the State Corporation Commission, after notice and opportunity for a hearing, shall conduct a proceeding every two years to determine the fair rate of return on common equity to be used by a Phase II Utility as the general rate of return applicable to rate adjustment clauses under subdivisions A 5 or A 6 of § 56-585.1. A Phase II Utility's filing in such proceedings shall be made on or before March 31 of 2017 and 2019.[1]

In addition, pursuant to Code § 56-585.1:1, the ROE approved in this proceeding will be used in the Company's triennial review proceeding commencing in 2021 to review Dominion's earnings

[1] Code § 56-585.1:1 C 2. Dominion is a Phase II Utility. *See* Code § 56-585.1.

on its rates for generation and distribution services for the successive 12-month test periods beginning January 1, 2017, and ending December 31, 2020.[2]

The Company requests that the Commission approve an ROE of 10.75% for Dominion's rate adjustment clauses approved under Subdivisions A 5 and A 6 of § 56-585.1 of the Code, to be applied prospectively, effective with the date of the Commission's final order in this proceeding, and to measure earnings in the 2021 triennial review proceeding.[3] Dominion currently has a total of ten such rate adjustment clauses.[4] Dominion asserts, among other things, that 10.75% represents the return required to invest in a company with a risk profile comparable to the Company.[5]

On April 3, 2019, the Commission issued an Order for Notice and Hearing, which, among other things, directed Dominion to provide notice of its Application, provided interested persons the opportunity to comment or participate in the proceeding, directed the Commission's Staff ("Staff") to investigate the Application, and scheduled an evidentiary hearing.

The following timely filed notices of participation: Department of the Navy, on behalf of the Federal Executive Agencies ("FEA"); Walmart, Inc. ("Walmart"); Virginia Poverty Law

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[2] Code §§ 56-585.1:1 A and C 3.

[3] Ex. 2 (Application) at 4.

[4] *See* Ex. 12 (Myers Direct) at 5. Dominion's rate adjustment clauses, and subsequent revisions thereto, approved under these statutes include Riders B, BW, C2A, GV, R, S, U, US-2, US-3, and W. In addition, the Commission approved a new rate adjustment clause, Rider E, on August 5, 2019; however, the Final Order in that case has been suspended pending the Commission's review of the Company's Limited Petition for Reconsideration. *See Petition of Virginia Electric and Power Company, For approval of a rate adjustment clause, designated Rider E, for the recovery of costs incurred to comply with state and federal environmental regulations pursuant to § 56-585.1 A 5 e of the Code of Virginia*, Case No. PUR-2018-00195, Doc. Con. Cen. No. 190910045, Order Granting Reconsideration (Aug. 26, 2019).

[5] Ex. 2 (Application) at 5.

Center ("VPLC"); Virginia Committee for Fair Utility Rates ("Committee"); and Office of the Attorney General, Division of Consumer Counsel ("Consumer Counsel").

On July 12, 2019, FEA, Walmart, VPLC and Consumer Counsel filed testimony.[6] On August 2, 2019, Staff filed testimony.[7] On August 16, 2019, Dominion filed rebuttal testimony and the Motion *in Limine* of Virginia Electric and Power Company ("Motion").[8] On September 4, 2019, Consumer Counsel filed a response to Dominion's Motion. On September 6, 2019, Staff and the Committee filed responses to Dominion's Motion. On September 6, 2019, the Company filed corrected pages to Company witness Hevert's Direct Testimony.

On September 10-11, 2019, a public hearing was convened to hear testimony and accept evidence on the Company's Application. At the conclusion of the hearing, the Commission notified the participants that post-hearing briefs and issues lists would be due October 18, 2019. Staff hereby files the following brief with attached list of issues.

II. COST OF EQUITY

A. <u>A Reasonable Market Cost of Equity Range for Dominion is 8.10% to 9.10%</u>

To determine a fair return on common equity for Dominion, Staff estimated the Company's cost of equity by applying well-established methodologies, including the Discounted Cash Flow ("DCF") model and risk premium analyses, including the Capital Asset Pricing Model ("CAPM"). Staff's cost of equity methodologies, analyses, and results are consistent with the guiding principles for determining the market cost of equity established by the Supreme

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[6] FEA filed the testimony of Kevin W. O'Donnell; Walmart filed the testimony of Steve W. Chriss; VPLC filed the testimony of Karl R. Rabago; and Consumer Counsel filed the testimony of J. Randall Woolridge, Ph.D.

[7] Staff filed the testimonies of Carol B. Myers, Philip M. Gereaux, and Donna T. Pippert.

[8] Dominion filed the rebuttal testimonies of Robert B. Hevert and John C. Ingram.

Court of the United States in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*"), and *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) ("*Bluefield*"). These cases established that the allowed equity return must be set equal to the cost of equity (and the overall return must be equal to the overall cost of capital) such that a utility is able to maintain its financial integrity and the ability to attract capital on reasonable terms and achieve earnings commensurate with returns on investments of comparable risk.

In the last two cases where Dominion's authorized ROE was litigated, the Commission found that "a market cost of equity within a range of 8.5% and 9.5% fairly represents the actual cost of equity in capital markets for companies comparable in risk to Dominion seeking to attract equity capital."[9] The Commission further found that the evidence supported an ROE of 9.0%.[10] The Commission, however, approved an ROE of 9.4% in the February 16, 2017 Order, and an ROE of 9.2% in the November 29, 2017 Final Order, based on the concept of gradualism in ROE determinations.[11] In both cases, the Commission stated that the Company's proposed cost of equity range of 10.25% to 10.75% "represents neither the actual cost of equity in the marketplace nor a reasonable ROE for the Company."[12] The Commission also found that the Company's continued use of (1) only earnings per share ("EPS") as the measure of growth in its DCF model,

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[9] *Application of Virginia Electric and Power Company, For revision of rate adjustment clause: Rider B, Biomass Conversions of the Altavista, Hopewell, and Southampton power stations for the rate year commencing April 1, 2017,* Case No. PUE-2016-00059, Doc. Con. Cen. No. 170220476, Order (Feb. 16, 2017) at 9 ("February 16, 2017 Order"); *Application of Virginia Electric and Power Company, For the determination of the fair rate of return on common equity to be applied to its rate adjustment clauses,* Case No PUR-2017-00038, 2017 S.C.C. Ann. Rept. 475, 476, Final Order (Nov. 29, 2017) ("November 29, 2017 Final Order").

[10] February 16, 2017 Order at 9; November 29, 2017 Final Order at 476.

[11] February 16, 2017 Order at 9-10; November 29, 2017 Final Order at 476.

[12] February 16, 2017 Order at 9; November 29, 2017 Final Order at 476.

(2) projected interest rates in its CAPM analysis, and (3) only earnings per share as the measure of long-term growth to develop the market risk premium component of the CAPM analysis, upwardly skewed, inflated and overstated the Company's cost of equity.[13] The Commission further rejected the Company's claims that certain business risks, including its planned capital expenditures, warranted the Company's recommended ROE, recognizing that over half of the Company's projected capital expenditure amounts would be recovered through rate adjustment clauses, "which permit the timely and current recovery of all reasonable and prudent costs on a dollar-for-dollar basis."[14]

Consistent with the principles of the *Hope* and *Bluefield* cases, Staff witness Pippert calculated a range of 8.10% to 9.10% for Dominion's market cost of equity.[15] Staff's cost of equity models, and the inputs to those models, are the same methodologies used by Staff in prior utility rate cases and accepted by the Commission for many years.[16] In contrast, the Company's market cost of equity analyses and resulting proposed cost of equity of 10.75% do not comport with the established principles of the *Hope* and *Bluefield* cases. The Company continues to use unreasonable inputs that impart an upward bias in its results, including projected interest rates;

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[13] February 16, 2017 Order at 10-11; November 29, 2017 Final Order at 476.

[14] November 29, 2017 Final Order at 477. *See also* February 16, 2017 Order at 11.

[15] Ex. 15 (Pippert Direct) at 3.

[16] *See, e.g., Application of Virginia Electric and Power Company, For a 2011 biennial review of the rates, terms, and conditions for the provision of generation, distribution, and transmission services pursuant to § 56-585.1 A of the Code of Virginia*, Case No. PUE-2011-00027, 2011 S.C.C. Ann. Rept. 456, 463, Final Order (Nov. 30, 2011) ("We find that the Staff's results...utilize reasonable proxy groups, growth rates, discounted cash flow methods, and risk premium analyses. We conclude that the methodology employed by the Staff is consistent with the public interest and that the results herein satisfy constitutional standards..."); *Application of Appalachian Power Company, For a 2014 biennial review of the rates, terms and conditions for the provision of generation, distribution and transmission services pursuant to § 56-585.1 A of the Code of Virginia*, Case No. PUE-2014-00026, 2014 S.C.C. Ann. Rept. 392, 401, Final Order (Nov. 26, 2014); *Application of Aqua Virginia, Inc., For an increase in rates*, Case No. PUE-2014-00045, 2016 S.C.C. Ann. Rept. 206, 209, Final Order (Jan. 7, 2016).

prior authorized returns; and only earnings per share as the measure of growth in its DCF model and as the measure of long-term growth to develop the market risk premium component of its CAPM analysis.

Dominion's authorized ROE has dropped gradually over the course of several ROE decisions since 2011. However, the Company has produced no evidence demonstrating that Dominion has had difficulty attracting capital at reasonable rates. In fact, Company witness Hevert acknowledged at the hearing that Dominion has been able to finance capital expenditures at reasonable rates and maintain a credit that is comparable to its peers.[17] The Company criticizes Staff's proposed cost of equity range of 8.1% to 9.1% as being "dangerous";[18] however, there is absolutely no reason for the 155-basis point increase in authorized ROE that the Company advocates.[19]

B. <u>Mr. Hevert did not change his recommended range or ROE recommendation even though several variables in his analyses have changed significantly</u>

Before discussing some of the flaws in Mr. Hevert's cost of equity analyses, it is important to point out that although some of the inputs in his models changed significantly between the time he performed his initial analysis and the filing of his rebuttal testimony, he did not update his recommended ROE and cost of equity range to reflect the changes in his model results.[20] As Staff witness Pippert testified, Mr. Hevert updated his analyses with market data through the end of June. This includes declines in the Current 30-Year Treasury, Near Term

[17] Tr. 91-92.

[18] Tr. 24.

[19] The Company's proposed ROE is even more puzzling in light of testimony that utilities have become less risky in recent years. Utility betas have decreased and interest rates have declined, resulting in declining capital costs. *See* Ex. 10 (Woolridge Direct) at 53; Tr. 122-24, 210.

[20] Ex. 19 (Hevert Rebuttal) at 6.

Projected 30-Year Treasury and Long-Term Projected 30-Year Treasury rates of 41 basis points, 55 basis points and 35 basis points, respectively.[21] He did not, however, include a summary of his new cost of equity model results in his rebuttal testimony. Accordingly, Staff introduced an exhibit at the hearing to illustrate how Mr. Hevert's rebuttal analysis impacted his model results.

Mr. Hevert's cost of equity model results for his DCF, CAPM, Enhanced Capital Asset Pricing Model ("ECAPM") and Bond Yield Plus Risk Premium approach in his direct testimony range from 8.25% to 12.76%. His updated rebuttal inputs produce a range of results from 8.09% to 11.06%.[22] Furthermore, 18 out of 28 of his DCF and risk premium model results are now below 10%, the bottom of Mr. Hevert's recommended range.[23] His own model results, as well as his use of inputs that this Commission has routinely rejected, lead to the conclusion that his recommended range of 10.0% to 11.0% and recommended ROE of 10.75% are highly inflated and unreasonable.

Mr. Hevert attempted to downplay the impact of his rebuttal inputs on the Company's current market cost of equity by introducing a chart at the hearing that shows a very gradual decline in ROEs since 2007 compared to a steeper drop in the 30-Year Treasury Yield during that time.[24] He asserted that there is not "a very strong correlation between those authorized returns and the level of Treasury yields."[25] Mr. Hevert also testified that since 2016, the trend in

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[21] *Id.*, Schedule 4, Schedule 5 at 1; Ex. 16 (Staff Update of Hevert Model Summary); Tr. 185.

[22] Ex. 16 (Staff Update of Hevert Model Summary).

[23] *Id.*

[24] Ex. 20 (Treasury Yield and ROE Comparison).

[25] Tr. 249. Interestingly, the August 15, 2019 Regulatory Research Associates ("RRA") Report, cited extensively by the Company, observes, "Interest rates have been the key factor driving authorized ROEs downward..." Ex. 18 (August 15, 2019 RRA Report) at 13.

authorized ROEs "has been flat" and "[t]here's virtually no trend" in spite of the continued overall decline in Treasury yields.[26] He subsequently acknowledged that there is a correlation between authorized ROEs and the trend in Treasury yields – it is just not in lockstep.[27] He attributes this to the inverse relationship between interest rates and risk premiums and seems to conclude that the downward drift in ROEs has ceased.[28]

Staff notes a few issues with Mr. Hevert's testimony in this regard. First, his chart comparing the trend in authorized ROEs and the 30-year Treasury Yield is flawed because it shows two different scales on the Y-axis.[29] A better chart can be found on page 12 of the August 15, 2019 RRA report.[30] That graph compares the decline in authorized ROEs and the 30-year Treasury Yield on the same scale over a 40-year period. It is true that both do not decline at the same rate; however, the inverse relationship between interest rates and risk premiums is not the only possible reason for the difference in trends. Regulatory lag is certainly one factor,[31] as is the principle of gradualism,[32] state laws (like Virginia) that restrict the extent to which

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[26] Tr. 251.

[27] *See* Tr. 269-70.

[28] *See, e.g.*, Tr. 251.

[29] Ex. 20 (Treasury Yield and ROE Comparison).

[30] Ex. 18 (August 15, 2019 RRA Report).

[31] *See, e.g.*, Tr. 134-36, 203.

[32] *See, e.g.*, Tr. 137, 263-64.

Commissions can lower ROEs,[33] as well as other variables that impact ROE determinations.[34] In sum, it is clear that authorized ROEs have declined along with the 30-year Treasury Yield.

C. Mr. Hevert Inappropriately Relies Exclusively on EPS Growth Rates in his DCF Analyses

Mr. Hevert relied exclusively on EPS growth rates for his proxy group DCF analysis and the market risk premium calculation in his CAPM analysis.[35] The Company's exclusive reliance on projected EPS growth rates is inappropriate and this methodology has been rejected by the Commission in the past.[36]

The fundamental theoretical premise of the DCF model is that the present value of a stock is equal to the discounted value of *all* future cash flows. As a stock is a perpetuity that has no fixed maturity, future cash flows on a stock are presumed to extend into infinity. While any individual investor will have a finite investment horizon, the value of that stock when it is sold will again be equal to the discounted value of all future cash flows from the stock at that (future)

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[33] Indeed, the peer group floor requirement in the Code is a statutory construct that makes this exercise not a true cost-of-equity analysis.

[34] Tr. 191. These variables include, but are not limited to, whether cases are litigated or settled, incentive ROE programs, and capital structure adjustments to address leverage issues. *Id.*

[35] *See, e.g.*, Ex. 3 (Hevert Direct) at 46.

[36] *See, e.g.*, *Application of Appalachian Power Company, For an increase in electric rates*, Case No. PUE-2006-00065, 2007 S.C.C. Ann. Rept. 321, 327, Final Order (May 15, 2007) (identifying a "significant bias[]" from the use of a growth rate that, like those used by Company witness Hevert in this proceeding, "primarily emphasized projected earnings per share growth rates and ignored other projected rates of growth for dividends, book value, and retained earnings to estimate a long-term sustainable growth rate assumed by the DCF model..."); *Application of Appalachian Power Company, For adjustment to capped electric rates pursuant to § 56-582 B (vi) of the Code of Virginia*, Case No. PUE-2007-00069, 2007 S.C.C. Ann. Rept. 474, 476, Final Order (Dec. 13, 2007) ("The Chief Hearing Examiner properly found that...the Company did not 'estimate a sustainable growth rate for the [DCF] model at the outset' and based its recommendation 'on results that reflect the remaining higher, but less sustainable projected growth rates;'..."); *Application of Aqua Virginia, Inc., For an increase in rates*, Case No. PUE-2014-00045, 2016 S.C.C. Ann. Rept. 206, 209, Final Order (Jan. 7, 2016) ("The Company uses unreasonable inputs, including an unreasonably high growth rate and projected interest rates. We have explicitly rejected the use of such inputs in previous cases...").

point in time.[37] The future cash flows are in the form of dividends and any capital gain (or loss) when the stock is sold.[38] Accordingly, Staff derived its estimated DCF growth rates from projected dividend growth rates, projected earnings growth rates and projected earnings retention growth rates.[39] Mr. Hevert's use of only EPS growth rates for his DCF analysis causes a 40 basis point difference between his results and the Staff's DCF results.[40]

D. Mr. Hevert Incorporates Inflated Expected Returns for the S&P 500 in his CAPM Analyses Because, Among Other Things, His EPS Growth Rates Are Inflated

Likewise, the Company's use of projected EPS in the DCF portion of its CAPM analysis produces a significant upward bias by overstating the return on the market (and consequently, the market risk premium) component of that cost of equity model. This is important, because the CAPM is the method Mr. Hevert favors in arriving at his recommended cost of equity range.[41] Mr. Hevert relied on projected earnings growth rates from Bloomberg and Value Line to develop his long-term DCF cost of equity estimates for the S&P 500,[42] resulting in expected returns on the S&P 500 of 13.68% (Bloomberg) and 16.81% (Value Line),[43] which he updated to expected returns of 14.88% and 14.78% in rebuttal.[44] Several of the expected returns for companies in the S&P 500 are on their face inflated and out of line with investor expectations.

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[37] Ex. 15 (Pippert Direct), Appendix B at 1.

[38] *Id.*

[39] *Id.* at 25, Appendix B at 5.

[40] *See* Ex. 17 (Impact of Hevert Rebuttal on Staff's Results).

[41] *See, e.g.*, Ex. 15 (Pippert Direct) at 7.

[42] Ex. 3 (Hevert Direct) at 54-55.

[43] *Id.*, Schedule 2 at 7 and 14.

[44] Ex. 19 (Hevert Rebuttal), Rebuttal Schedule 2 at 7 and 14.

For example, the growth estimates by Bloomberg and Value Line for Amazon.com, Inc. ("Amazon"), were 37.60% and 57.00%, respectively, at the time Mr. Hevert conducted the analysis for his direct testimony.[45] At the time of his rebuttal testimony, these growth estimates by Bloomberg and Value Line for Amazon had changed to 44.95% and 39.00%, respectively.[46] These estimates are excessive and, due to the weight in the S&P 500 for Amazon, these growth estimates have a significant impact on Mr. Hevert's estimated required market return.[47] At least one investment research service (Zacks), a source used by Mr. Hevert in his DCF analysis,[48] warns against reliance on "analysts' rosy forecasts" of "very high earnings growth rates over the next five years" because "analysts are not good at seeing too far into the future."[49] This source further states, "High growth rates exceed 35%-45% per year."[50] If Amazon is removed from the S&P 500, Mr. Hevert's return on the market would drop roughly 1.5%. This is a huge impact on the return on the market and demonstrates the peril of reliance on excessive EPS growth rates.

Using his inflated estimates of the expected return on the S&P 500, Mr. Hevert calculates market risk premiums of 10.65% (Bloomberg) and 13.77% (Value Line) for his direct testimony.[51] His rebuttal market risk premiums are 12.25% and 12.15%.[52] By contrast, Staff's

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[45] Ex. 3 (Hevert Direct), Schedule 2 at 1 and 8.

[46] Ex. 19 (Hevert Rebuttal), Rebuttal Schedule 2 at 1 and 8.

[47] *See* Tr. 102-5; Ex. 3 (Hevert Direct), Schedule 2 at 1 and 8; Ex. 19 (Hevert Rebuttal), Rebuttal Schedule 2 at 1 and 8.

[48] *See, e.g,* Ex. 3 (Hevert Direct) at 48-49.

[49] Ex. 6 (Zacks Aggressive Growth Investing).

[50] *Id.*

[51] Ex. 3 (Hevert Direct), Schedule 2 at 1 and 8.

[52] Ex. 19 (Hevert Rebuttal), Rebuttal Schedule 2 at 1 and 8.

CAPM market risk premium is 6.91%.[53] Mr. Hevert's excessive estimates of this component of the CAPM significantly inflate his risk premium cost of equity estimates.[54] As noted above, the Commission has repeatedly rejected Mr. Hevert's overstated market risk premium in his CAPM analysis. Substituting his expected return on the market into Staff's analysis in this case would increase Staff's CAPM results by approximately 300 basis points.[55] On the other hand, substituting Staff's 12% return on the market[56] into Mr. Hevert's ECAPM formula would drop his *highest* result of 11.06% to 8.94%.[57] These large differences emphasize the degree to which his overstated estimates of expected returns on the S&P 500 cause his recommendation to be out of touch with reality.

Although Mr. Hevert believes historical market risk premiums are not appropriate for use in the CAPM,[58] he did address the historical market risk premium at the hearing in the context of trying to justify a utility equity risk premium of over 800 basis points for Dominion.[59] Rather than address the appropriateness of this risk premium for a utility, however, Mr. Hevert reverted to talking about the market risk premium. He testified that, holding constant the total market return and using a 2% risk-free rate, the historical market risk premium of 6.91% should be

[53] Ex. 15 (Pippert Direct) at 7, 28. Staff uses the annually updated long-horizon historical market risk premium that is described in the *2019 SBBI Yearbook, Stock, Bonds, Bills, and Inflation, U.S. Capital Markets Performance by Asset Class 1926-2018*, Duff & Phelps, Chicago, Illinois. *See* Ex. 15 (Pippert Direct) at 28, Schedule 6, and Appendix C at 8.

[54] Ex. 15 (Pippert Direct) at 7.

[55] Ex. 17 (Impact of Hevert Rebuttal on Staff's Results); Tr. 187.

[56] Ex. 15 (Pippert Direct), Appendix D at 130; Ex. 17 (Impact of Hevert Rebuttal on Staff's Results).

[57] Ex. 17 (Impact of Hevert Rebuttal on Staff's Results).

[58] Ex. 3 (Hevert Direct) at 55.

[59] *See* Tr. 80, 266-67.

adjusted upward to 10%.[60] His testimony on the stand, however, ignored certain important components in the risk premium analysis. Mr. Hevert omitted any discussion at this point in the hearing of how the utility beta in the CAPM analysis would impact a market risk premium of 10% and make it applicable to a utility. Even if a market risk premium of 10% for the S&P 500 is incorporated into Mr. Hevert's CAPM analysis, using his Bloomberg beta of 0.490 would produce a utility risk premium of only 490 basis points and a CAPM result of 6.9% (assuming a risk-free rate of 2%). Applying his Value Line beta of 0.587 would produce a utility risk premium of 587 points and a CAPM result of 7.87%.

In sum, Mr. Hevert's estimates of the expected return on the S&P 500 are inflated, which, in turn, produces excessive market risk premium estimates in his CAPM analysis. His CAPM methodology leads him to a recommendation that overstates Dominion's equity risk premium.

E. <u>Mr. Hevert's Use of Projected Interest Rates Also Imparts an Upward Bias in His Results</u>

Although Mr. Hevert did not exclusively use projected interest rates in his risk premium analyses, he did use the Near-Term Projected 30-year Treasury yield in his CAPM and both the Near-Term and Long-Term Projected 30-year Treasury Yields in his Bond Yield Risk Premium analysis. Accordingly, Mr. Hevert's use of long-term projected interest rates continues to influence his recommended range (as a result of his primary reliance on his risk premium model results),[61] in spite of the Commission's rejection of projected interest rates as inputs in these models.[62] The Commission has repeatedly approved Staff's use of current rates, and there is a

[60] Tr. 266-67.

[61] *See, e.g.*, Ex. 3 (Hevert Direct) at 4, 43.

[62] *See, e.g.*, November 29, 2017 Final Order at 476; *Application of Appalachian Power Company, For the determination of the fair rate of return on common equity to be applied to its rate adjustment clauses*, Case No, PUE-2016-00038, 2016 S.C.C. Ann. Rept. 393, 395, Final Order (Oct. 6, 2016).

continuing downward trend in interest rates. Conversely, Mr. Hevert's ROE recommendation reflects a rising trend in rates, which has not materialized.[63] Staff, therefore, recommends that the Commission reject the projected interest rates used by Mr. Hevert in his analyses and continue to rely on recent actual rates as reflected in Staff's methodology.[64] Staff's 2.91% rate for the 30-year Treasury bond is clearly reasonable in light of trends in the market from the end of May to the time of the hearing.

F. <u>Mr. Hevert Inappropriately Relies on Past Authorized Returns in His Bond Yield Plus Risk Premium Analysis</u>

Mr. Hevert's cost of equity analysis is inappropriately influenced by prior authorized returns in other jurisdictions. He gives little weight to his DCF model results on the basis that "the model has produced results (*i.e.*, mean results) consistently and meaningfully below authorized returns."[65] He also looks at authorized returns in vertically integrated electric utility rate cases reported since 2016, compares them to the RRA rankings for those jurisdictions,[66] and concludes that "utilities in jurisdictions considered to be more supportive tend to be authorized somewhat higher returns."[67] Mr. Hevert also uses prior authorized returns in his Bond Yield Plus Risk Premium Model.[68]

On a high level, prior authorized returns in other jurisdictions should be given little, if any, weight in the determination of the market cost of equity for Dominion. As discussed above,

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[63] Ex. 15 (Pippert Direct) at 10.

[64] *See id.* at 9-11.

[65] Ex. 3 (Hevert Direct) at 4.

[66] *See id*, Schedule 8.

[67] *Id.* at 37.

[68] *Id.* at 61-62.

there are many variables that impact ROE determinations, including regulatory lag, the principle of gradualism, whether cases are litigated or settled, incentive ROE programs, and capital structure adjustments to address leverage issues.[69]

Moreover, Mr. Hevert's conclusion that utilities in jurisdictions considered by RRA to be more supportive tend to be authorized somewhat higher returns makes little sense in light of his statement that less supportive environments (so deemed by RRA) are associated with higher levels of risk (and conversely, more supportive environments would be associated with lower levels of risk).[70] Mr. Hevert advocates that higher levels of risk require a higher authorized ROE. It would seem then that jurisdictions considered to be more constructive/supportive, and therefore associated with lower levels of risk, would have lower authorized returns. According to Mr. Hevert's conclusion regarding the RRA rankings and authorized returns, one would expect a decrease in Virginia's RRA ranking (discussed below) to result in a lower authorized ROE, which he is certainly not advocating in this case, as discussed further below. Regardless, his Schedule 8 is of little value because it does not (1) identify whether the cases were settled or litigated, (2) provide the effective dates of the RRA rankings, or (3) include any information about factors specific to each jurisdiction and each utility. There is no causal connection that can be drawn from the data in that chart.

[69] *See, e.g.*, Tr. 134-37, 191, 203, 263-64.

[70] Ex. 3 (Hevert Direct) at 36.

G. <u>The Company Inappropriately uses RRA's Ranking of Virginia to Justify Its Inflated ROE Recommendation</u>

Much has been made by the Company of the RRA August 15, 2019 report, in which RRA lowered the ranking of Virginia regulation from Above Average/2 to Above Average/3.[71] A bit of background is necessary in order to explain why this should be given little credence in the Commission's determination herein. First, RRA's rankings of the regulatory climate for energy utilities in each jurisdiction evaluated are subjective in nature and assigned from an *investor* perspective, indicating *relative* regulatory risk associated with ownership of utility securities in that jurisdiction.[72]

Second, RRA assigns rankings in three categories: Above Average, Average, and Below Average. An Above Average ranking means "in RRA's view, the regulatory climate in the jurisdiction is relatively more constructive than average, representing lower risk for investors..."[73] Interestingly, RRA describes an Average ranking as implying "a relatively balanced approach on the part of the governor, the legislature, the courts and the commission when it comes to adopting policies that impact investor and consumer interests."[74] An Above Average ranking would seem to indicate then that the regulatory climate is viewed by RRA as being more pro-investor.

Within each category, the designations 1, 2 and 3 indicate relative position, with a 1 implying a more constructive relative ranking within the category, a 2 indicating a midrange

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[71] *See, e.g.*, Ex. 19 (Hevert Rebuttal) at 12-13, 19; Tr. 17, 24-25 (counsel for the Company called RRA's latest ranking action "a signal of a deteriorating regulatory climate in Virginia"), 227-38.

[72] Ex. 18 (August 15, 2019 RRA report) at 1, 7.

[73] *Id.* at 2.

[74] *Id.*

ranking, and a 3 indicating a less constructive ranking within the category.[75] Although RRA lowered Virginia's ranking to Above Average/3, Virginia is still one of only eight jurisdictions in the Above Average category, indicating that RRA still views Virginia as a utility investor-friendly jurisdiction. Furthermore, Staff's and the Respondents' recommended ROEs in this case are not the sole factor influencing RRA's determination. RRA also cites the Subsection A 6[76] Rider adders that are beginning to expire, large commercial customers seeking to aggregate load and procure electricity competitively, and political pressures to deregulate.[77] On the other hand, one factor about this jurisdiction that favors investors, which is referenced in the RRA report but ignored by the Company, is Virginia's earnings sharing plan set forth in Code § 56-585.1.[78]

In any case, by its own criteria, it appears that RRA may have "jumped the gun" in lowering Virginia's ranking. According to the August 15, 2019 RRA Report, RRA considers two aspects when evaluating an individual rate case and the overall regulatory environment: (1) how the authorized ROE compares to the average of authorized returns nationwide over the 12 months immediately preceding the decision; and (2) whether the utility has been accorded a reasonable opportunity to earn the authorized return in the first year of the new rates.[79] This is not, however, a rate case, and RRA lowered Virginia's ranking prior to any final order in this case. Furthermore, the ROE authorized herein will be used to set rate adjustment clause rates,

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[75] *Id.*

[76] Code § 56-585.1 A 6.

[77] Ex. 18 (August 15, 2019 RRA report) at 3.

[78] *See id.* at 14 ("Generally RRA views as constructive the adoption of alternative regulation plans that are designed to streamline the regulatory process and cost recovery or allow utilities to augment earnings in some way.... The use of plans with somewhat broader scopes, such as ROE-based earnings sharing plans, is, for the most part, considered to be constructive...").

[79] *Id.* at 12.

which provide dollar-for-dollar recovery and are adjusted and trued-up every year. Accordingly, Dominion will have more than "a reasonable opportunity to earn the authorized return..."

III. PEER GROUP FLOOR

A. Appalachian Power Company, Mississippi Power and South Carolina Electric & Gas Company Belong in the Peer Group

While the evidence in this case supports Staff's suggested ROE range of 8.1% to 9.1% with a midpoint of 8.6%, the Code places an additional restriction on the Commission's determination of ROE. Specifically, Code § 585.1 A 2 provides that

> the fair rate of return on common equity applicable separately to the generation and distribution services of such utility, and for the two such services combined, and for any rate adjustment clauses approved under subdivision 5 or 6, shall be determined by the Commission during each such triennial review, as follows:
> a. The Commission may use any methodology to determine such return it finds consistent with the public interest, but such return shall not be set lower than the average of the returns on common equity reported to the Securities and Exchange Commission for the three most recent annual periods for which such data are available by not less than a majority, selected by the Commission as specified in subdivision 2 b, of other investor-owned electric utilities in the peer group of the utility subject to such triennial review, nor shall the Commission set such return more than 300 basis points higher than such average.
> b. In selecting such majority of peer group investor-owned electric utilities, the Commission shall first remove from such group the two utilities within such group that have the lowest reported returns of the group, as well as the two utilities within such group that have the highest reported returns of the group, and the Commission shall then select a majority of the utilities remaining in such peer group. In its final order regarding such triennial review, the Commission shall identify the utilities in such peer group it selected for the calculation of such limitation. For purposes of this subdivision, an investor-owned electric utility shall be deemed part of such peer group if (i) its principal operations are conducted in the southeastern United States east of the Mississippi River in either the states of West Virginia or Kentucky or in those states south of Virginia, excluding the state of Tennessee, (ii) it is a vertically-integrated electric utility providing generation, transmission and distribution services whose facilities and operations are subject to state public utility regulation in the state where its principal operations are conducted, (iii) it had a long-term bond rating assigned by Moody's Investors Service of at least Baa at the end of the most recent test period subject to such triennial review, and (iv) it is not an affiliate of the utility subject to such triennial review.

That is, the Commission may not set the ROE in this proceeding less than the average historical earned return for a majority of a specified group of peer utilities. The Code provides that the peer group includes all investor-owned electric utilities that are (1) principally located in the Southeastern United States; (2) with a long-term bond rating assigned by Moody's Investors Service of at least Baa at the end of the most recent test period, and (3) not an affiliate of the subject utility. From this group, the Commission is to exclude the two highest and two lowest earned returns. The Commission may then choose any of the remaining utilities in its peer group average, so long as the subset comprises at least a majority of the remaining utilities.

In this case, the parties agree that ten utilities should be included in the peer group. The Commission thus has to decide whether to include any or all of three remaining utilities: Appalachian Power Company ("APCo"), South Carolina Electric and Gas Company ("SCE&G") and Mississippi Power. Staff's analysis included all three of these utilities.[80] The Company's analysis excluded all three.[81]

The Code requires that a company be included in the peer group if "its principal operations are conducted in the southeastern United States east of the Mississippi River in either the states of West Virginia or Kentucky or in those states south of Virginia, excluding the state of Tennessee." Company Witness Hevert excluded APCo because it serves more customers in Virginia than it does in West Virginia.[82] As Staff witness Gereaux notes, however, the APCo operating division of American Electric Power Company is headquartered in West Virginia and a

[80] Ex. 13 (Gereaux Direct) at 3.

[81] Ex. 3 (Hevert Direct) at 38-40.

[82] *Id.* at Schedule 10; Ex. 13 (Gereaux Direct) at 6.

majority of the power generated by APCo comes from plants located in West Virginia.[83] The Code does not define "principal operations," but Staff submits that it should include more than a mere customer count, and in this instance supports a conclusion that APCo meets the requirements for inclusion in the peer group.

While APCo presents a legal issue that has not heretofore been resolved by the Commission, Mississippi Power clearly satisfies all provisions of the Code. Its principal operations are conducted in the Southeastern United States. It has a long-term bond rating assigned by Moody's Investors Service of at least Baa. It is not an affiliate of DEV. Therefore, as Staff witness Gereaux states, it should be included in the peer group.[84] Company witness Hevert, on the other hand, claims that Mississippi Power should be excluded from the peer group because it had negative returns in 2016 and 2017, and was rated below Baa until an August 2018 upgrade.[85] The Code does not permit the Commission to exclude companies from the peer group based on the alleged nonrecurring events identified by the Company, and states that a utility shall be included in the peer group if they meet the identified criteria. Therefore, the Commission is statutorily required to include Mississippi Power.

Finally, the Company excluded SCE&G because it became an affiliate of DEV on January 1, 2019.[86] Thus, SCE&G was an affiliate of DEV at the time the Petition was filed and will be an affiliate during the time the ROE set in this case is in effect, but was not an affiliate for the duration of the test period used to establish the ROE. As discussed above, the Code gives the

[83] Ex. 13 (Gereaux Direct) at 6-7.

[84] *Id.* at 5-6.

[85] Ex. 3 (Hevert Direct) at 40.

[86] *Id.* at Schedule 10; *see also* Dominion Energy Virginia Motion *in Limine*, filed on August 26, 2019.

Commission broad discretion in determining the applicable ROE in this case, so long as (1) it does so using a 12-month test period ending on December 31, 2018, and (2) the ROE is no lower than a floor established by the average earned returns of a statutory peer group of investor-owned utilities meeting certain parameters. The statutory peer group analysis is by its very nature backward-looking. The General Assembly has determined that when the Commission sets the ROE for the Company going forward, such ROE can be no lower than the historic returns of a group of utilities by and large not subject to Commission jurisdiction. As a backward-looking analysis, the peer group evaluation must have a fixed beginning, a date from which the Commission looks backward.

The Company argues that this date is the date this proceeding commenced, and thus, because SCE&G became an affiliate of the Company in 2019, it should be excluded from the peer group. The General Assembly, however, has already answered this question, when it dictated that this proceeding use a 12-month test period ending December 31, 2018. This requirement appears in § 56-585.1:1, which governs all aspects of this proceeding, including but not limited to the peer group analysis set forth in § 56-585.1 A 2 b. Therefore, because SCE&G was not an affiliate of DEV for the duration of the test period, and because it meets all of the other criteria for inclusion in the peer group, it should be included. The statutory analysis is inclusive – all utilities meeting the statutory requirements should be included, with the Commission granted discretion to determine what subset of those utilities establishes the ROE floor (so long as the subset is at least a majority of the overall group after excluding the two highest and two lowest returns).

Therefore, the Commission should begin its peer group analysis with a group of 13 utilities that includes APCo, SCE&G and Mississippi Power.

B. The Commission has the Discretion to Measure the Peer Group Floor Using Either Year-End Equity or Average Equity

The Code does not specify whether the average of the returns on common equity for the peer group should be measured using year-end equity or average equity. The Commission has the discretion to use either. Although the Commission has in the past used average equity to calculate the peer group floor, the Commission has stated that it is reasonable to use either average or year-end equity.[87]

Using Staff's peer group, after excluding the two highest and two lowest returns, the peer group floor would be either 8.75% (if the Commission uses year-end equity) or 8.97% (if the Commission uses average equity), for the reasons described by Staff witness Gereaux.[88] Both of these floors are within the range identified by Staff witness Pippert, although each exceeds the midpoint of this range.

IV. CUSTOMER BILL IMPACT AND CAPITAL BUDGET

The ROE established in this proceeding will be used to set rates for the Company's rate adjustment clauses ("RACs") pursuant to Code §§ 56-585.1 A 5 and A 6 as of the date of the Commission's final order in this proceeding; and be used to measure earnings in the Company's first triennial review proceeding for the four successive test periods of 2017 through 2020 pursuant to Code § 56-585.1 A. Staff witness Myers explained that each ten basis points of ROE has an annual revenue requirement impact of approximately $9.5 million for the Company's Virginia jurisdiction, including both Subsection A 5 and A6 RACs and base rates, and therefore

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[87] *Application of Appalachian Power Company, For the determination of the fair rate of return on common equity to be applied to its rate adjustment clauses*, Case No. PUR-2018-00048, Doc. Con. Cen. No. 181120212, Final Order (Nov. 7, 2018) at 6.

[88] Ex. 14 (Alternate Staff Peer Group Results).

the Company's proposal to increase the ROE by 155 basis points from 9.20% to 10.75% results in an increase to the annual revenue requirement of approximately $147.4 million.[89] An annual revenue requirement increase of $147.4 million translates to a potential $2.89 increase in a monthly bill for a residential customer using 1,000 kilowatt hours, including $1.96 for base rates and $0.93 for RACs.[90]

The Company asserts that, because the Commission cannot increase base rates in the triennial review proceeding, the ROE set in this proceeding will have no impact on customer bills for base rates.[91] However, Mr. Ingram concedes that the ROE set in this proceeding can have an effect on potential customer refunds or Customer Credit Reinvestment Offsets.[92] As Staff witness Myers explained, the Company would get to keep more money than they otherwise would before any sharing mechanism would kick in.[93] Company witness Ingram claims that a reduced refund does not have a bill impact because it is not ongoing, but it is clear that a refund has an effect on customer bills during the period the refund is paid. The ROE established in this proceeding may not have a direct effect on customer <u>rates</u> from base rates, but it most certainly will impact customer <u>bills</u>.

Finally, as Staff witness Myers noted, there was a discrepancy between the projected five-year capital budget provided by the Company in this proceeding and the budget presented

[89] Ex. 12 (Myers Direct) at 5-7.

[90] *Id.* at 7.

[91] Ex. 25 (Ingram Rebuttal) at 5.

[92] Tr. 315-317.

[93] Tr. 141.

by the Company to investors.[94] Staff requests that the Commission direct the Company to provide the most current budget of projected capital spending in all future ROE proceedings.

V. CONCLUSION

For the reasons stated herein, Staff requests that the Commission approve its recommended cost of equity range of 8.10% to 9.10% and set the Company's approved ROE within that range. Staff also requests that the Commission deny the Company's Motion *in Limine*, and accept Staff's testimony regarding including SCE&G in the peer group analysis.

Respectfully submitted,

STAFF OF THE STATE CORPORATION COMMISSION

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Dated: October 18, 2019

[94] Ex. 12 (Myers Direct) at 12; Tr. 147.

CERTIFICATE OF SERVICE

I hereby certify that on this 18th day of October, 2019, a true copy of the foregoing "Post-Hearing Brief of the Staff of the State Corporation Commission" was electronically mailed and mailed, postage prepaid, to all persons on the official Service List in this matter. The Service List is available from the Clerk of the State Corporation Commission, c/o Document Control Center, 1300 East Main Street, First Floor, Tyler Building, Richmond, Virginia 23219.

LIST OF ISSUES

Issue	Description of Staff's Position
1. Return on Equity ("ROE")	1. Dominion's cost of equity falls within a range of 8.10% to 9.10%, with a midpoint of 8.60%.
a. Cost of Equity	a. Cost of Equity
i. Market Cost of Equity	i. Staff recommends that the Commission establish Dominion's fair ROE within a range of 8.10% to 9.10%.
ii. Peer group companies	ii. The statutory peer group should include Mississippi Power, Appalachian Power Company and South Carolina Electric & Gas Company.
iii. Peer group floor	iii. The peer group floor is either 8.75%, based on year-end equity, or 8.94%, based on average equity. Both floors fall within Staff's recommended cost of equity range. Staff does not take a position on whether one or the other is the correct measure. The Commission has the discretion to use average or year-end equity to calculate the floor and the Commission has never precluded the use of year-end equity for this purpose.
b. Base rate and RAC impact	b. Each ten basis points of ROE has an annual Virginia jurisdictional impact of approximately $9.5 million. The annual revenue requirement impact of the Company's proposed ROE of 10.75% is $147.35 million.

2. Capital spending budget	2. The Company should be directed to provide the most current budget of projected capital spending in all future ROE proceedings.